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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF ARIZONA PUBLIC SERVICE COMPANY FOR A HEARING TO DETERMINE THE FAIR VALUE OF THE UTILITY PROPERTY OF THE COMPANY FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON, TO APPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN, AND TO AMEND DECISION NO. 67744	Docket No. E-01345A-05-0816
IN THE MATTER OF THE INQUIRY INTO THE FREQUENCY OF UNPLANNED OUTAGES DURING 2005 AT PALO VERDE NUCLEAR GENERATING STATION, THE CAUSES OF THE OUTAGES, THE PROCUREMENT OF REPLACEMENT POWER AND THE IMPACT OF THE OUTAGES ON ARIZONA PUBLIC SERVICE COMPANY'S CUSTOMERS.	Docket No. E-01345A-05-0826
IN THE MATTER OF THE AUDIT OF THE FUEL AND PURCHASED POWER PRACTICES AND COSTS OF THE ARIZONA PUBLIC SERVICE COMPANY.	Docket No. E-01345A-05-0827

Arizona Corporation Commission
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RUCO'S EXCEPTIONS

The Residential Utility Consumer Office ("RUCO") files these exceptions to the Chief Administrative Law Judge's Recommended Opinion and Order ("ROO") dated April 27, 2007.

RUCO recommends that the ROO be modified on two issues: Capital Structure and Return on Equity.

CAPITAL STRUCTURE

The ROO adopts the Company's adjusted end-of-test-year capital structure of 45.5 percent long-term debt and 54.5 percent equity, on the basis that "it is the capital structure existing at the end of the test year and will continue to support the Company's existing financial profile and maintain its investment grade credit rating."[1] The regulator, however, needs to look at not just the actual capital structure, but also at what is an optional capital structure. Too much or too little equity can result in a higher than necessary cost of capital and, as a result, render an actual capital structure imprudent. It is not unusual for a utility regulator to base rates on a capital structure that contains less equity than the utility actually has, on the basis that the actual capital structure may be imprudent.[2]

RUCO recommended a capital structure of 50 percent debt and 50 percent equity. Such a capital structure is prudent and appropriate for rate making purposes, because it is similar to the capital structure of APS' parent, which is a higher risk investment than APS. Pinnacle West, Inc.'s capital structure over the most recent five-quarter time period consisted of 50.20% common equity, 49.06% long-term debt and 0.74% short-term debt.[3] On a consolidated basis, Pinnacle West has higher operating risk than APS.[4] A business with higher operating risk should have less debt and more equity since its income stream is more

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[1] ROO at 43.
[2] David Parcell, The Cost of Capital—A Practitioner's Guide, 4-22, (1997)
[3] Exh. RUCO-11 at 26 (Hill direct).
[4] Exh. RUCO-11 at 26 (Hill direct).

risky and less debt is appropriate to avoid default.[5] For rate making purposes, it is **not** appropriate for APS to have a capital structure with less debt and more equity than its higher-risk parent.

A 50-50 capital structure also has more common equity than APS has utilized in the past. The Company has maintained a capital structure of 55% long-term debt and 45% common equity while maintaining investment-grade bond ratings.[6] However, just prior to filing its application in this proceeding, APS' parent company infused equity into APS, bringing APS' equity ratio up to approximately 54% of total capital.[7] The increase in the percentage of APS' equity from 45% to 54%, if adopted for rate making purposes, would cost Arizona's ratepayers approximately an additional $58 million annually.[8]

Finally, APS' actual capital structure contains a higher equity ratio than that of electric utilities in both its general and specific proxy groups, and therefore APS' capital structure reflects a lower financial risk than that exhibited by the proxy groups.[9]

A 50-50 capital structure will provide a better balance of the interests of ratepayers and stockholders, because it is a more economically efficient (less costly) capitalization than that requested by the Company.[10] The attached Exhibit A is a suggested amendment to adopt a 50-50 capital structure.

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[5] Exh. RUCO-11 at 27 (Hill direct).
[6] Exh. RUCO-11 at 24 (Hill direct).
[7] Exh. RUCO-11 at 24-25 (Hill direct).
[8] Exh. RUCO-11 at 24-25 (Hill direct).
[9] Exh. S-8 at 19 (Parcell direct).
[10] Exh. RUCO-11 at 32 (Hill direct).

RETURN ON EQUITY

The ROO correctly notes that the Discounted Cash Flow ("DCF") method of estimating the cost of equity has long been favored by the Commission[11], and that market measures such as the DCF are superior to comparative analyses (such as the Comparable Earnings Method ("CEM")) because they involve "fewer unproved (and sometimes unprovable) assumptions."[12] The parties' DCF results were as follows:

APS:	9.0% [13]
Staff:	9.0% – 10.0% [14]
RUCO:	9.44% [15]

The ROO then goes on to adopt a 10.75 percent cost of equity.[16] The ROO justifies its radical departure from the DCF results on the basis of "APS' current bond rating as well as the Company's continued growth and the capital costs associated with that growth."[17]

RUCO is not suggesting that the Commission ignore other measures of return on equity other than the DCF. But the ROO itself acknowledges that the DCF is the most reliable indicator of equity costs. The Commission should not deviate so dramatically from DCF results as the ROO does. The ROO's proposed adoption of a cost of equity that is 75 basis points above the highest DCF proposal is inappropriate. First, Staff itself believes that its lower-end DCF result of 9.0% "represents the upper values for the average median results, while the

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11 ROO at 48, 49.

12 ROO at 44, quoting Decision No. 55228.

13 Exh. APS-41 at 42 (Avera direct). At the hearing, Dr. Avera testified that applying the most recent data would result in a ROE recommendation of 10%. Tr. at 1871 (Avera). RUCO believes that using the data provided by Dr. Avera in support of his updated DCF of 10%, the result would be 9.6 or 9.7 percent. Tr. at 2023 (Hill).

14 Exh. S-8 at 24 (Parcell direct).

15 Exh. RUCO-11 at 42 (Hill direct).

16 The parties' recommendations for cost of equity were: APS 11.50%, Staff 10.25%, RUCO 9.25%. *See* ROO at 44. APS "virtually ignored" its DCF results in it final recommendation. Exh. S-8 at 35 (Parcell direct).

17 ROO at 49.

upper end (10 percent) reflects the high value of the constant growth DCF calculations for the groups examined."[18] Additionally, APS' recent growth rates have declined from what they were in the mid-1990's.[19] Further, the average Standard & Poors business risk score for the electric sample group companies that RUCO's witness used in computing his 9.44% DCF result is 6—the same as that for APS.[20] Finally, both the capital structure adopted by the ROO, and the 50-50 capital structure advocated by RUCO, have considerably more common equity and less debt than average for the sample group. Thus APS, prospectively, will have less financial risk than the sample group, and therefore should be awarded a return on equity below the mid-point of a reasonable range.[21]

RUCO believes that a cost of equity much lower than the ROO's proposed 10.75% is appropriate. Exhibit B, attached, is a suggested amendment to lower the cost of equity finding.

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[18] Exh. S-8 at 24 (Parcell direct).
[19] Tr. at 3375 (Diaz Cortez).
[20] Exh. RUCO-11 at 42 (Hill direct).
[21] Exh. RUCO-11 at 43 (Hill direct).

RESPECTFULLY SUBMITTED this 15th day of May 2007.

Scott S. Wakefield, Chief Counsel

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Secretary to Scott Wakefield

Exhibit A
(adopts a 50-50 capital structure)

Page 43, lines 21-24

DELETE current paragraph

REPLACE WITH

> "We find that a capital structure of 50% equity and 50% debt is appropriate for rate making purposes for APS at this time. It would be inappropriate to adopt APS' actual capital structure that has more equity than its higher-risk parent. Further, the 50-50 capital structure has more common equity than APS has used in the past and will provide additional financial security during the Company's construction period."

(and conforming amendments)

Exhibit B
(adopts a lower return on equity)

Page 49. line 10

DELETE sentence beginning "We are congnizant.." through the end of the sentence.

Page 49, line 14

DELETE "10.75"

INSERT "___"

(and conforming amendments)